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SIPDIS

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SUBJECT: US-SRI LANKA TIFA DISCUSSIONS AN OPPORTUNITY TO
MOLD GSL PRIORITIES, FRAME GSL EXPECTATIONS

REF: A. COLOMBO 1702

1B. COLOMBO 1717
1C. 03 COLOMBO 1673

Classified By: Ambassador Jeffrey J. Lunstead. Reasons 1.4 B, D and E

11. (C) Summary: The GSL delegation for TIFA, headed by Commerce Minister Fernandopulle, is looking forward to discussions with USTR during the next round of talks on October 26. The delegation will seek to convince the USG of the GSL's continued commitment to economic reforms (while true for most members of the GSL delegation as individuals, the jury is still out on the Government as a whole). They will likely cite recently released economic data showing growth continuing above 5% and the Finance Ministry's assertion that the budget deficit will remain at 8% of GDP this year, dropping to 5% within two-three years.

12. (C) Summary cont'd: The delegation will be eager to hear from USTR the status of the GSL's request for an FTA. Despite constant efforts by Post to tamp down expectations, the GSL remains keenly interested in an FTA, partly under pressure from the garment sector and partly in search of a "good housekeeping seal of approval" for its economic plan. US issues to raise include IPR, the Millennium Challenge Account, investment climate/commercial issues, and support for US positions in the WTO. End Summary.

13. (SBU) As the USG prepares for the upcoming round of Trade and Investment Framework Agreement talks, it should take note that it faces a new GSL, with a less disciplined approach and a short-term economic outlook, a situation which is compounded by the impending expiration of the Multi-Fiber Agreement in January. There is likely to be a bit of disappointment on the GSL side regarding the agenda, which they had hoped would be more inclusive and substantive on the issue of bilateral trade (despite numerous Embassy efforts to tamp down expectations in light of political uncertainties in Sri Lanka and the upcoming US elections).

GSL Players

14. (C) Commerce Minister Jeyaraj Fernandopulle will lead the delegation and will likely be accompanied by Tourism and Industries Minister Anura Bandaranaike (President Kumaratunga's brother) and Board of Investment Chairman Saliya Wickramasuriya. Fernandopulle has slowly increased his comfort level on international trade matters but is still heavily reliant on his Director General, former GSL Rep to the WTO, Ambassador K.J. Weerasinghe, who will also accompany. Weerasinghe is a thoughtful, focused public servant who would serve as a good sideline interlocutor, along with GSL Ambassador Devinda Subasinghe, for the US side. Bandaranaike has been generally positive on the notion of increased trade with the US, but not particularly engaged or helpful on commercial matters. BOI Chairman Wickramasuriya, a recruit from the international private sector, is smart, non-political and engaging. He has been focused primarily on reorganization of the BOI and its internal management, however, and actually soliciting investment has been a secondary focus so far.

Economic Situation

15. (SBU) Economic activity and outlook has been mixed since the President's decision to take over three ministries last November and the ensuing period of political jockeying, including the April elections and the breakaway of LTTE-renegade leader Karuna. A recent poll of businesses showed business confidence at its lowest point in the last two years (the lowest since the LTTE attack on the international airport in 2001). Nonetheless, the industrial and services sectors continue to perform well, as Western Province (i.e. Colombo) growth continues. The stock market has also shown strong returns, buoyed by tourism-related

stocks - whose index values have doubled since December. It is currently ranked as the best performing stock market in Asia.

16. (U) On the macroeconomic front, growth for the first half of 2004 was 5.7%, down from the same period last year. Inflation is on the rise with oil price hikes a leading factor. Monetary policy remains a bit loose (according to members of the Central Bank (CB) monetary board, the CB is allowing money supply to grow in the hopes that the GSL will cut price subsidies, thus sopping up excess liquidity) and the increased balance of payments deficit (caused by a suspension of World Bank and IMF budgetary support) is forcing continued depreciation of the rupee. First half economic conditions are reported thoroughly in Ref A.

GSL Issues at TIFA

17. (SBU) The GSL delegation is coming to Washington with one issue on their mind, a US-SL FTA. They will try to steer the meeting to a discussion of all the steps they have taken since the last TIFA round in October 2003, in response to US suggestions. These included signing the WTO Information Technology Agreement (which is still outstanding - Finance Ministry and Cabinet must approve the duty concessions) and sponsoring a visit by Sri Lankan apparel manufacturers to the Carolinas (which took place last month). While the Embassy has made strong efforts to keep expectations in check and tamp down any notion that an FTA could be pursued this year, the impending MFA expiration and pressure, particularly from garment manufacturers, keeps the issue at the forefront of US-Sri Lanka economic relations. They will also likely raise domestic concerns, focusing primarily on the needs of the agriculture and small and medium enterprise (SME) sectors - citing the recent change in government as evidence of a need to balance reform, liberalization and globalization trends with the needs of the rural poor. While we should acknowledge the importance of addressing the needs of all levels of society and seeking broad-based growth, it is important that the USG remind Sri Lanka of its position as a trade-based nation with strong international ties. The GSL should not let the need to address domestic concerns overwhelm their policies in the international trade arena and thus cause the engine of growth to sputter.

Suggested Points:

--We appreciate Sri Lankan Government efforts to take on board many of our suggestions from last year's TIFA round and would be interested to hear about your experience and the outcomes of these pursuits.

--While we note the enhanced focus of your Government on the needs of the rural and SME sectors, we think it is important that Sri Lanka recognize its strong position as a trading nation and the broad success the country has realized through economic reform and trade liberalization.

--AM sure you realize that in the long-term, reducing poverty in Sri Lanka will not come from subsidies and increased government employment, but from creating an environment to spur private sector growth.

--There are many options around the world for investors. Sri Lanka needs to make the right decisions and show the right investment climate in order to foster additional FDI and economic growth.

USG Issues at TIFA

18. (U) Post understands the TIFA agenda currently includes the following issues: Sri Lankan Economic and Investment Policies; the Millennium Challenge Account; IPR; and Bilateral Trade Relations (including FTA).

Sri Lankan Economic and Investment Policies

19. (SBU) Commercial Disputes and Investment Climate: While this topic is discussed comprehensively in Ref B, the TIFA discussion gives an excellent opportunity to reinforce our views that US companies operating within BOI zones and in the growing services sector are having great success and taking advantage of the growing Sri Lankan market and access to India. The overall investment climate remains mired in uncertainty, however, as the Government continues to send mixed signals on its economic policies and fails to employ prompt, clear decisionmaking in the investment approval process. US businesses recognize potential in Sri Lanka, particularly in the infrastructure development and services sectors, and could offer significant assistance in the agricultural sector. The onerous process of working with the Government, however, is crowding out potential investors and expertise.

¶10. (C) Economic Reform: Economic reform remains largely on hold with the GSL. Privatization continues to be demonized. The most recent casualty stems from a decision to halt selection of a party to take over a one-third interest from the state-owned oil company in the petroleum retailing sector. Twelve state-owned strategic enterprises have been lumped under a new entity run out of the President's office, the Strategic Enterprise Management Agency (SEMA), headed by Senior Presidential Advisor Mano Tittawella. SEMA's role is to provide a protective "buffer" around these strategic enterprises, insulating them from political influence and allowing the boards to hire professional managers and operate more as a private-sector entity, with focus on the bottom-line, productivity and profit, while still maintaining Government control of essential services. In theory, this is a fine idea, but whether Tittawella has the political heft to provide this insulation is unknown. He has been helpful in resolving commercial disputes in some sectors in the recent past.

¶11. (SBU) The previous Government reduced the size and scope of the government bureaucracy. Following its election in April, however, the current GSL decided to hire 27,000 unemployed college graduates to reduce unemployment rolls. Further, there have been promises of up to 70% salary increases and enhanced benefits (though during a recent conversation with the Ambassador, the Finance Minister assured that in reality, the raises would be much lower).

Suggested Points:

--We would be interested to hear an update on the economic reform process.

--In particular, since privatization has largely been abandoned, we would like to know the status of the Strategic Enterprise Management Agency and its efforts to streamline and modernize state institutions.

--We would also appreciate knowing the status of efforts by the National Committee for Economic Development and the new Government Procurement Agency.

--All three organizations seem to have critical roles to play in helping push the economy forward.

IPR

¶12. (SBU) After passage of the new IPR Law in November 2003, the government of Sri Lanka, the Embassy, and the Embassy-led private sector Working Group have worked together to begin enforcement. Numerous training sessions were organized by the Embassy for Police and Customs with the participation of US Customs from New Delhi, the International Federation of the Phonographic Industry (IFPI), and BSA Microsoft. These supplemented sessions for Police, Customs and the business community that were led by the GSL Intellectual Property Office Director. With Embassy assistance, IFPI gave the Police a manual on how to investigate IPR violation cases, and gave Customs handy reference brochures to help identify counterfeit goods.

¶13. (SBU) The Embassy also sent four lawyers and a Commercial High Court Judge to the US on a special International Visitors Program on IPR protection. The GSL has incorporated IPR Law into the curriculum at the Police Academy, and has created special IP task forces within the AG, Police and Customs. The government has begun enforcement efforts, with a crackdown on counterfeit local music products. A recent raid also uncovered a CD and DVC printing plant, with numerous counterfeit CDs, many of which were US music, movie and software titles. The raid reflected solid police work, but US company representatives worry that the government may not be able to make a strong enough case against the defendants.

Points:

--Piracy remains a major concern.

--The recent raid shows that there is domestic production of counterfeit goods as well as imports.

--We are encouraged that the Police have conducted some raids, and hope that the GSL follows these cases with diligence through the legal proceedings.

--We hope the GSL ensures that the Police and Customs are given the support they need to make seizures and give testimony with confidence.

--The Embassy and the IPR Working Group have offered their continued assistance with training sessions, information on legitimate product identification and other support as

requested by the GSL.

--Many will be watching to see how Sri Lanka handles these new cases.

--We hope to see more raids, leading to prosecutions, and a reduction of counterfeit products in the marketplace.

--We look to Sri Lanka to be the leader in South Asia in IPR protection, with a concurrent rise in confidence by prospective investors.

Millennium Challenge Account

¶14. (C) The GSL has been slow to take up the MCA challenge (Note: recently the MCC indicated it had already received concept papers or compact proposals from 13 of the 16 eligible countries. Post only last week received a partial draft of the GSL's initial concept paper. End note). While claiming to be thoroughly consulting with NGOs and private sector chambers around the country, there is little evidence of any significant outreach. The GSL has submitted a partial draft concept paper to the Embassy, but we continue to await their final draft for submission to MCC. Slow going on the MCA front is due to several factors:

--GSL rejection of the former Government's Poverty Reduction Growth Facility (PRGF) program (Regaining Sri Lanka) and few discussions with the World Bank and IMF about developing a new plan.

--Pressure to develop its own budget (the current GSL has adopted the previous Government's budget through November, when the new budget submission to parliament is due). There is significant pressure on the GSL to differentiate itself from the former Government's policies, particularly with regard to assistance to the agricultural sector, accompanied by the inconvenient reality that the Government coffers are virtually empty.

--The new Finance Secretary has released virtually all members of the senior Ministry staff with relevant experience (either as a result of personal or policy differences) and is relying on the highly bureaucratized national planning office to take up the mantle.

¶15. (SBU) While it is not too late to take advantage of the MCA opportunity, the GSL risks being the last one out of the gate unless significant high-level pressure is applied to this initiative soon. In particular, the GSL needs to engage the opposition parties, donor community, business community and domestic and international NGOs to build support for its initiatives (MCC made very clear that one of the first responses to a proposed compact would be to vet it with civil society).

Suggested Points:

--MCA program poised to become a key model of delivering assistance, can be used as a framework for looking at a country's complete assistance portfolio.

--We are concerned that Sri Lanka still has not completed its concept paper and that little publicity has been given to the consultative process.

--We would appreciate knowing what your timeframe is for submission of a compact proposal, how the consultative process has gone and what additional efforts are underway to build broad-based support for the initiative.

Bilateral Trade Relations

¶16. (U) Trade between the US and Sri Lanka continues to be a one-way street, three-quarters of which involves the export of Sri Lankan-made garments to the US. In 2003, Sri Lankan exports to the US were US\$ 1.8 billion (US\$ 1.5 billion of which was garments). US exports to Sri Lanka have been in decline for several years and in 2003 were US\$ 154 million (Note: Post continues to look into this figure, as we believe it does not fully capture the strengths of US "exports" including services, education, and items re-exported from other countries in the region. End note).

¶17. (U) Post has recently received funding from the Department to pursue a study on how to use the Indo-Lanka Free Trade Agreement to create opportunities for US companies to export to the Indian market via Sri Lanka. American goods are popular in Sri Lanka and potential for increased exports exists.

¶18. (SBU) Perhaps the single largest impediment to US exports is the Government procurement process. In the past year, several opportunities have been squandered due to non-transparent tender processes, or interminable delays due

to bureaucratic inertia. US companies lost out on opportunities for upgrading the radar at the international airport (despite having technically superior products and pointing out that the Italian firm that won could not perform the work at the price bid), opportunities to be part of the "third-player" in the petroleum sector (due to GSL reneging on earlier privatization contract obligations), opportunities to bunker fuel for ships in Colombo port (due to restrictions placed on outside bunkering facilities after the privatization process had been initiated). Two US power companies continue to have payment problems and have been forced to suspend operations in this power-starved country (in one case the non-payment has taken place following a GSL request for Embassy intervention with the company to restart operations after a plant accident. The company acceded to the request.).

¶119. (SBU) The GSL has touted a newly formed Government Procurement Agency as a solution to this problem. To date, however, this entity has not made the same headway as its new sister agencies the Strategic Enterprise Management Agency and the National Council for Economic Development.

Suggested Points:

--We are concerned about the declining trend in US exports to Sri Lanka, particularly as Sri Lanka continues to improve its access to US markets.

--We appreciate the efforts of the Sri Lankan garment sector to visit North Carolina and look for sourcing opportunities in the US. We encourage continued efforts on that front.

--US companies currently have a very difficult time operating in Sri Lanka, due to political intrusion into the market and poor Government procurement practices.

--We would appreciate an update on how the Government of Sri Lanka intends to rectify its government procurement practices.

--In particular, we would like to stress the need for resolution of payment disputes with US companies in the power sector and the need to expedite approvals for US companies seeking to invest in Sri Lanka.

WTO

¶120. (SBU) Sri Lanka has continued to play a supportive role in the WTO and in moving the Doha agenda forward. During our discussions, they continue to acknowledge that their long-term views are more in line with US policy and that they intend to be supportive of progress on the multilateral front. During a recent meeting with Econoffs and business sector representatives, however, Commerce DG Weerasinghe noted that support on the multilateral front would also be driven by progress on the bilateral front - laying down a clear marker that Sri Lanka believes they should get more (i.e. an FTA) for their cooperation.

¶121. (SBU) It should be noted, however, that the GSL does face some local criticism for its support for progress in the WTO (which is labeled as pandering to the US position) rather than showing solidarity with its developing country brethren.

The GSL has looked closely at its interests, however, and appears ready to continue to play the helpful role it has adopted. It is important that the USG continue to reinforce that we understand Sri Lanka's position alongside us in the WTO stems from a sophisticated consideration of Sri Lankan interests in global trade talks, rather than some sort of "gimmick" to garner US support or concessions on other fronts.

Points:

--USTR and State points on US policy toward the WTO and US-SL FTA as appropriate.
LUNSTEAD